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The War in Europe

THE tremendous events of the last thirty days of course throw into the discard all previous estimates of the economic situation the world over. The world dreaded war, and despite the tension of the past year was slow to believe that war would come, within 21 years after November 11, 1918. No catastrophe comparable to the war of 1914-18 had been known in the history of mankind. History is mainly about wars, but over most of the past populations were small, and fighting was man to man. No such destruction of life or of wealth accumulations, no such interruption of normal life, as in modern war, was possible. The economic system, in its organization and exchange of services, was comparatively simple, even down to the wars of Bonaparte, when there were no railroads, and but little machinery of any kind. Industry was by the handicrafts, transportation by animal power or sailing ships, trade mainly between neighbors and little disturbed by distant wars.

By 1914, railroads, paved roads and automotive traffic had revolutionized land transportation; steamships were connecting all continents; and not only electric cables but Marconi's wireless were flashing messages around the world. The facilities for trade were multiplied and the variety of production and exchange of goods and services was infinitely greater, all for the benefit of the people engaged. The industrial and financial organization had become almost incomprehensibly complex, and its parts were mutually dependent in a degree never approached before.

The war of 1914-18 violently disrupted this organization. Its costs have never been computed and cannot be, for they include not merely the taxes paid and debts unpaid, but the inestimable value of millions of lives, and the cost of the disorganization of trade from then until now. Monetary systems have been wrecked, currencies have become worthless or depreciated, and billions of values have been destroyed.

Lessons of 1914

Most people will form their opinions of the effects of the present war by what they know of the last one, and when they do so should take account of the depression as well as the boom. The last war started a rise of prices and wages that continued into 1920. It is natural that prices should advance in war, which destroys goods, causes shifts of production, and interferes with transportation. However, the rise was not a benefit, but the contrary. Scattered individuals gained, as in the case of farmers who sold wheat at $3.50 a bushel, corn at $2.36, hogs at $23.50 a hundred weight, or cotton at 43¾c a pound, provided the receipts were used to pay off debts. But not many farmers, or others, stopped there. War industries made money during the boom, but lost it, and more, in the depression. The rise in wages brought only an illusion of prosperity, for most of the time it trailed the rise in the cost of living.

We know now that the most disastrous effects of the war were suffered after the war was over, and especially after 1929 when the shortages caused by the war had been made good and the inflation of that time had run its course. The problems of agriculture to this day trace back to the war prices and the abnormal and temporary stimulus to cultivation and new developments. Moreover, prices and wages did not come down together after the wartime inflation. Farm prices dropped more than industrial prices, and hourly wage rates least of all, and the disorder in price and cost relationships which then originated has persisted. This disruption of prices and trade relations has ruined tens of thousands of business men, including farmers, and thrown millions of wage-workers out of employment.

The bottom of the great depression, which was due to the war, was 14 years after its end, but the chain of economic sequences from 1914 to 1939 has been unbroken. The fiscal and monetary problems, the difficulties of unemployment, relief, social security, etc., and now the new war in Europe, with its new problems

for ourselves — all have a direct line of descent from August, 1914.

It is a strange idea that holds "business" responsible for wars. The aims and methods of "business" are vindicated by the ever increasing and widening distribution of goods to the homes during the century to 1914. "Business" wants peace, order, production, mutual services, and good faith in all relations. It deplores disorder and waste, and is appalled to be confronted by another war. Its problem now is to avoid, so far as possible, a repetition of the costly experiences of the last twenty-five years.

Will History Repeat Itself?

The new war is one month under way, and the uppermost question is, "Will history repeat itself?" No one knows how long the war will last, how widely it may spread, how intensive the fighting will be or how great the destruction. These are the keys to what lies ahead, and doubtless the outlook will change often. An early peace would reverse many recent developments.

History may seem to be repeating itself through the sensational advance in commodity prices, which started the first day of the war and amounted to 20 per cent on the average in less than a week, according to Moody's index of 15 staples. This exceeds anything that occurred until after the first full year of the last war. However, the rise is obviously due to domestic influences, to anticipations, and to memory of the 1915-1920 rise rather than, so far, to actual war demands. The element of scarcity, prominent in the last war, is lacking. The first rise then was chiefly in food prices, and there is no scarcity of food in the world today, nor can be unless next year's crops are greatly reduced. The fact that nearly all countries are subsidizing agriculture because prices are too low is evidence of the plentiful supply.

Moreover, production can readily be increased in most agricultural commodities, in areas removed from the battlefields, and undoubtedly will be if prices tend to advance. Production of important staples has been restricted by international agreement, and there is room to step up output of these commodities as quickly as necessary. The production facilities of the whole world are vastly greater and more flexible than in 1914, and a far greater proportion lies outside the war zone. Present indications are that shipping facilities will be more adequate than in the last war.

Wheat in Chicago has risen 20c. In 1914, Russia was the chief shipper to Western Europe and the Russian supply was cut off. Now Russia is a minor factor in the wheat markets. Canada, Australia and the Argentine have doubled their pre-war production, and these three countries alone have a surplus for export and carryover in 1939-40 of around 900,000,000 bushels, or half as much again as the world's entire import requirements last season.

Sugar had a violent advance upon the war news, but panic and unjustified hoarding pushed the rise to extremes. Actually the sugar supply is ample, and the panic was over even before President Roosevelt's action in abolishing the sugar quotas. What effect a long war might have on the sugar situation is unpredictable, but the position differs from 1914. The United Kingdom then depended heavily upon Continental beet sugar, but now uses hardly any, drawing on Cuba and her own possessions and dominions; and production in many areas can be increased.

Hogs had a sharp rise of $2.50, and have since lost half of it. Estimates of inspected hog slaughter for next twelve months run around 47,000,000, compared with 40,000,000 in the preceding twelve months and 34,580,000 in 1937-8. Hides and wool have advanced around 50 per cent. The British Government has taken over the sale of the Australian wool clip, but how much will be available for this country, and at what price, is not yet known.

Restrictions on copper production abroad have been removed, so that Great Britain will supply her needs from African and Canadian producers whom she can pay in sterling. These mines plus those of the Belgian Congo may supply France also. The copper situation bears little resemblance to that in the last war, when the United States supplied 60 per cent of world production. Now we have about a third of the world's producing capacity, and domestic copper as a rule is a minor factor in the world markets.

Rationing and Price Controls

It is agreed that if the war lasts and fighting is active the belligerents will need more of many commodities than in the last war, that they realize their needs better than in August 1914, and that they may buy earlier. But they also know better that they must economize in their consumption and drive their own production hard. Before 1914 war was fought mainly by professional armies and in 1914 some believed it would be fought by professional armies again. The talk in England was of "business as usual," and an effort was made to maintain as "normal" business as possible, the word signifying a minimum of governmental interferences. But events soon proved that the whole population was involved, and that "business as usual" was impracticable. There is no pretense in the countries engaged that business will be as usual in this war. The industries will be concentrated on the production of goods for war, at the expense of every day consumption of other goods, and in order to give priority to armament needs imports

are being subjected to license and consumers' goods are being rationed, in varying degrees, from the beginning.

All the countries engaged have had experience with war time inflation and all dread it. It is appalling that the national debts to be incurred for this war will be piled upon unpaid debts carried over from the last one, to which have been added the debts of the depression. Manifestly, no effort will be spared to control inflationary price tendencies, both to keep down costs and to ease the adjustments that will have to come after the war; and this leads, as it is already doing, to fixing prices, wages and hours, to restrictions on non-essential activities, and to further increases in taxes that are already almost insupportable. How effective the efforts may be only time can tell, but all appraisals of the outlook, including calculations as to commodity prices, will have to take the controls and the rationing into account.

World Prepared for War

This war has been expected and prepared for in all countries. The preparation has not only cushioned the shock, reduced the financial disturbance, and permitted markets to remain open which were closed in 1914, but it has simplified the changeover to war. German business has long been upon a war basis to a great extent, short of maintenance of the forces in the field and the destruction of material; and the democracies have moved in that direction to a degree which would have been deemed fantastic not many years ago. Business has been supported by armament expenditures, and exporters shipping to these countries have already been supplying war needs. War work has had priority, as if war were being waged. Labor and materials have been allocated to armament and reserve supplies accumulated. There has never been a like case where the step from peace to war was such a short one, and where the "war boom" to such an extent had preceded the war.

Moreover, the totalitarian countries have been striving to the utmost to increase their self-sufficiency, through development of synthetic and substitute materials, usually inferior or more expensive than the natural products, and through tariffs and quotas to stimulate their own production, usually uneconomical and at the expense of the standard of living. Other countries have had similar policies, and world trade has had to be adapted to them. These are adjustments to the war basis which in 1914 had to be made after the war started. The decline in the importance of international trade is shown by the League of Nations' calculation that although the industrial production of the world is 50 per cent above that of 1913, the volume of world trade is only 15 per cent greater. The disruption due to war is lessened by this growth of self-sufficiency.

The Foreign Trade Prospect

Will history repeat itself in a great expansion of the foreign trade of the United States, as in 1914-18? The rise in those years, partly due to higher prices, is shown in the following table:

U. S. Foreign Trade (In Millions of Dollars)

Year	Exports to Five Allies*	Exports to Latin America	Total Exports	Total Imports
1913	915	339	2,484	1,793
1914	931	258	2,114	1,789
1915	2,162	352	3,555	1,779
1916	3,554	531	5,483	2,392
1917	3,855	734	6,234	2,952
1918	3,656	728	6,149	3,031

*Great Britain, France, Italy, Russia, Belgium.

Though the net result in the years given was a tremendous gain, war cuts both ways in foreign trade. It will cut off almost all exports to Central Europe (the total to the present Germany, Poland and Danzig in the fiscal year 1939 was $135,000,000), and make shipments difficult to some other countries. It will reduce sales of some commodities to the Allies and certain neutrals, because of the controls upon imports and consumption and the abnormal strain on the normal means of payment for their purchases. On the other hand sales of war commodities will pick up greatly if the war lasts, and exports to countries which hitherto have bought from the combatants should improve.

Business in this country will move more soundly if it does not pitch expectations of trade with the belligerents too high. The situation differs from 1914 in significant ways. There is uncertainty as to what our neutrality laws will be, and their effect when they are promulgated. Mention has been made of the greater self-sufficiency of the warring countries, their preparations, and the wider sources of supply open to them.

Opportunities in Neutral Trade

In neutral countries the war will enlarge the opportunities open to our exporters, through the blockade of German and now also Polish trade overseas, and through the probable diversion of some British and French production from export to home uses. Nearly half of German merchandise exports, which amounted to Rm. 5,620,000,000 in 1938, will be affected by the blockade, most importantly those to Latin America, Africa and Asia. In view of the home needs it will likely be difficult for Germany to increase her exports to countries which she can still reach.

The United States looks forward principally to greater trade with Latin America. Some indications as to the extent of the opportunity may be had from the following table, showing the sources of imports into Latin America.

Imports of 20 Latin American Countries in 1937
(In Millions of Dollars)

	Imports from							
	U.S.	U.K.	Germany	France	Italy	Japan	Others	Total
Argentina	78	100	52	20	22	17	193	482
Brazil	76	40	79	8	5	5	118	331
Chile	26	10	23	2	2	2	23	88
Colombia	46	18	13	3	1	....	15	96
Peru	21	6	12	1	1	2	16	59
Uruguay	6	8	5	1	2	2	21	45
Venezuela	45	8	12	2	2	3	14	86
Mexico	106	8	27	6	2	3	18	170
Cuba	89	6	6	3	....	1	25	130
Others	62	11	23	3	2	11	32	144
Total	555	215	252	49	39	46	475	1,631
%	34	13	16	3	3	3	28	100

The German trade may almost disappear, although shipments may be possible through Italy. In the last war the exports of the Allies to Latin America dropped off, though less than might have been expected. From 1913 to 1918 the decline in British exports to this area, in value, was about £10,000,000, or 20 per cent. Doubtless the Allies will make desperate efforts to maintain their exports in order to conserve their gold and foreign currency resources. Nevertheless, the market for American machinery and metal products, chemicals, coal and other goods should be enlarged.

The critical factor will be the ability of the Latin-American countries to keep up their purchases, which will depend upon their own export shipments. In the enthusiasm for developing exports the fundamental truth should not be overlooked that trade is a two-way exchange. If Argentine meats, grains, hides and wool, Cuban sugar, Chilean nitrates and other products are in greater demand at higher prices, as in the last war, producers of these things will buy more of other goods. But producers who have been selling important quantities to Germany, largely under barter arrangements, which is the case with Brazilian coffee and cotton, are losing markets. In the long run these countries cannot buy except as they sell, and conversely if the United States expects permanently to improve its exports to them it must arrange to admit more imports from them also.

The Inflationary Danger

In the long view the influences which may moderate the price rise and the trade boom in this country may be looked upon as an unmixed blessing. There are enough influences of the other kind to make the restraining factors welcome. The gravest danger that the war holds for the United States, apart from that of being drawn in, is the danger of a repetition of the vicious spiral of the last war in which prices, wages and living costs fruitlessly chased each other upward.

There is little fear, for the most part, that the price advances which have already occurred have, of themselves, made the business situation unstable, for they have been chiefly in raw materials and semi-manufactured goods dominated by raw materials. Raw materials in general were low relative to finished goods prices, and farm prices were low relative to prices of things farmers buy. Business is benefited by equitable price relationships, and the rise has been in that direction. In some commodities, where a larger production is now needed, the higher prices may be necessary to obtain it.

Nor can any great damage be done by intelligent and informed protection of requirements. However, miscalculations are made; and misinformation and misinterpretations get into circulation, and lead to an uninformed speculation which is a menace. There is a difference between intelligent foresight and such manifestations of fright or ignorance as food hoarding and indiscriminate speculative commitments.

Granted that war has a disturbing influence upon prices, the business community is vitally concerned in limiting this influence so far as possible, by counteracting it where this can be done. Attempts to make speculative profits by price advances based upon temporary and unsound conditions increase living costs and foster demands for higher wages, thus getting the whole economic situation on stilts, with collapse inevitable, as in 1920, 1929 and 1937. Business and labor have a common interest in protecting the stability of their working relations. The same self-restraint may be needed in considering new projects which temporarily may seem profitable, but in peacetime could not pay their way.

Business is concerned to safeguard its future against these dangers. Moreover, it must keep its own record clear. If it fails to curb excesses the Government will step in with controls, and possibly make mistakes of its own. Finally, the Government also should put its fiscal house in order. With improving business, need for relief should diminish. If the Government through deficit financing bids against rising private demands for labor and materials, an inflation of prices will result.

Undoubtedly the understanding of this danger is far more general than in 1914. Experience then was a hard teacher. An encouraging number of industries have extended current prices in the face of rising raw materials and of the virtual certainty that they could make price increases stick, at least temporarily. Reassurances as to supplies available have been publicly given, and panic and speculation allayed. The leaders have taken the longer view, knowing that if they discourage the boom they will save themselves from the reaction.

Domestic Business Conditions

Prior to the outbreak of war opinions were uncertain as to the first effect upon domestic business, but the answer was only a few hours

in coming. Commodities rose at once as described, and after brief unsettlement stock prices jumped almost as sharply. This set the key for business. The flood of orders that reached the industries in the following days was immense, in some cases exceeding any like period on record; and industrial operations and freight movements turned upward sharply in response. Previous estimates of production levels for the next few months are now seen to have been hopelessly low, in view of this unforeseen change.

Business was moving into the Fall in an upward trend, and the elements of strength were impressive. Preparations against trade disorder had been made; distributors' commitments and stocks of goods and manufacturers' holdings of raw materials were low; production evidently was not outrunning consumption; there was underinvestment rather than overinvestment in capital goods; commodity prices were supported by various production controls and other measures; and Government spending continued at the peak.

These influences supported business against the war shock, and the memory of the export trade and the price rises of the last war provided the push upward. Almost over night business has gone off the hand-to-mouth basis, replenished inventories, and extended commitments. The war brought about the change, but the actual war business has not been the significant factor. Domestic orders have far outweighed the export orders, even where the latter have picked up most quickly, as in metal products and foods. Evidently business was ready to go ahead whenever any incentive appeared, or confidence was established. Probably it has been ready to do so at other times during the depression.

The Upturn in the Industries

At the beginning of September steel mill operations were running around 63 per cent of capacity; production, orders, and shipments were well balanced, and further moderate gains were expected to be maintained for a number of weeks in the Fall. However, orders during September have risen substantially above full capacity, and operations in the last week of the month were around 84 per cent. Most of the steel companies will apply present prices to deliveries through the end of year, but as scrap has risen $7 a ton to $23.25 in Pittsburgh, and pig iron $2 to $22.50, there is no assurance that prices will hold for the first quarter. This leads consumers to build up stocks, and the production rate is expected to move still higher.

Sales of cotton goods by mills in the Labor Day week were the heaviest on record, and during the month are estimated to have equalled four months' production. Goods prices and manufacturing margins have improved substantially. There was reason for this, for the mills have had a long and unprofitable period during which margins were the lowest in many years. Woolen goods business has been as large as the mills would accept, stimulated by the rise in raw wool and tops. Three times during the month goods lines were repriced, the total markup amounting to 50 to 55 cents a yard on staple worsteds. The price of rayon yarn (viscose) is up 2 cents, and rayon goods are higher on active business. Silk has continued its sensational rise to above $3, despite the difficulty of determining wherein the war will reduce the production or increase the consumption of silk, and hosiery prices have had to be marked up again.

Now that conditions are better for the mills the two textile workers' unions have announced that they will move for a 20 per cent wage increase. But if this is granted, and not offset by greater productivity, the mills will have to have the present or higher prices and margins permanently, and probably the increase would start another rush of forward buying; in other words, it would be an element in the dreaded inflationary spiral. On the other hand, if the situation is left to resolve itself competition should hold down prices. There is no lack of raw cotton or spindles or looms to supply the country's needs, and experience shows that when prices and profits improve production rises until prices come down again. Probably the textile unions may not be impressed by this argument. They will say with apparent logic that when their employers make more money they should have more pay, but the question goes deeper,—will the new prices hold, and are the mills making more than a fair profit? The danger is that if similar demands were made on all the industries, and all granted, costs and prices would rise to offset the higher money wages, and the increased pay would either be absorbed by the rise in the cost of living, or would result in unemployment due to the inability of people who were not receiving the higher wages to pay the higher prices. The experience of 1937, to say nothing of the last war, warns against allowing the upswing to become a "vicious circle". Both price and wage increases are charged with a public interest.

Sales Records Broken

Leather business has broken all records, with hides up 5½ cents, and shoe prices have been raised. Lumber sales have reached the highest level since 1930, and flour production is the highest in ten years. The rush in the wholesale foods business is described as the greatest ever known, with increased export demand for staple foods a factor. Paper business has been heavy, and prices are up in some grades, although newsprint quotations have been reaffirmed; the policy of the manufacturers is not to discourage demand, but to

increase operations and employment. Tire replacement business has been stimulated, and factory schedules for the fourth quarter will be higher than previously estimated.

The automobile industry is contributing to the improvement, independent of the foreign situation, which may have an unfavorable effect by reducing exports of passenger cars. However, the rise in domestic purchasing power is probably more important. Schedules of Fall assemblies are based on optimistic views of the outlook, and the industry is expected to be in full swing on 1940 models by the middle of October, with a probable output of 400,000 cars a month thereafter.

Demand for non-ferrous metals and metal products has been heavy, and early in the month 130,000 tons of copper was sold in five days. Producers since have limited sales. Coal, which will benefit from industrial revival and probably greater export demand, has advanced in price and production is climbing rapidly, already up to almost 9,000,000 tons weekly, the best since early 1937. Electric power production has set two consecutive all-time records.

Finally, railway freight car loadings have exceeded all predictions, and totaled 815,000 in the week ended September 23, with the Fall peak still to be reached. The railroads have had to race to repair equipment to take care of this unforeseen traffic. According to Railway Age, the number of freight cars in serviceable condition represents 3,000,000 tons less carrying capacity than in 1936, and there were small car shortages in the 1936-37 period, with peak loadings less than 850,000 cars a week. However, the American Railway Association is confident that by prompt handling the traffic can be carried without hampering business. Meanwhile the roads have rushed equipment orders, which are an important factor in the steel improvement. On the above indications of car loadings, they may have better earnings than in the Fall of 1936, and possibly spend more on equipment than they did then. These orders will be in production for months to come, irrespective of foreign developments.

In Conclusion

The foregoing is an impressionistic summary, all portraying a sharp rise; and at the moment there are hardly any reports of the opposite character that could be offered to tone the summary down. Evidently the increase in production that has set in during September still has strong momentum, and will carry further, with the 1936-37 peak within reaching distance. The best level of the Federal Reserve Board's index of industrial production during that recovery was 121 in December, 1936; while in August of this year, before the turn-around, the index was 102.

It is not too early to consider what the situation will be if the rise in production is as sharp as indicated. For the next step, the goods will have to pass into consumption, and while consumption will naturally increase, along with greater industrial employment and higher farm income, there will inevitably be a period during which inventories mount; and in that interval productive activity may be vulnerable to a relapse again. In many products what has occurred thus far is not an increase of consumption, but a shift of existing stocks nearer the consumer, from manufacturer to distributor, and from the producer of the raw material to the manufacturer. So far retail sales have shown no pronounced improvement over the August level, which, however, was somewhat better than in July.

Business men know that after a spurt of heavy buying and increased production a let down is usual. There was such a reaction in the latter part of 1933, after the Summer rush, and early this year, after the upswing in the Fall of 1938. The real question is "How different is the situation now?" What influences can carry business continuously forward?. On the favorable side, increased exports in some lines should help to absorb the increase in production; the tendency will be to carry larger inventories because of the conviction that the long trend is upward; and investment in plant and equipment should pick up. Unquestionably as production rises old plants have to be modernized and facilities extended. The railway equipment business already developing is an example. The utilities will spend more money on plant.

For the present, however, it would be futile to attempt to measure these influences precisely, and to predict whether they will absorb the increasing production, validate the price rises that have occurred, and fend off the reaction. The answer will have to be sought in the industrial and trade reports, and the war news, of the coming months.

The Course of Interest Rates

When the war broke out in the closing days of August, the volume of excess reserves held by American banks was the largest in history and the level of interest rates was lower than ever before. For nineteen years, or since the culmination of the commodity price boom in 1920, the broad trend of interest rates, as represented by the yield of high grade bonds, has been downward, despite intermediary contrary movements of varying duration and intensity. The diagram on the next page, based upon yields and prices of United States government long-term bonds, very clearly reveals the existence of this long-term trend.

It is interesting to note that this long movement seems to have gone through three separate and distinct phases. From 1920 to about the end of 1927 interest rates fell sharply, due

first to the collapse of the 1920 boom and later to the inflow of gold and to the easy money policies pursued by the Federal Reserve Banks.

Next came an interval of about six years when rates fluctuated violently, though in a generally horizontal plane. During this period the country experienced the great stock market inflation of 1928-29, and a subsequent great deflation involving recurrent credit crises, the net effect of which was to halt for a time the downward tendency of money rates.

In 1934 the decline was resumed, largely as a result of the great gold inflow that followed the devaluation and stabilization of the dollar on January 31, 1934. By mid-summer last the average yield on the long-term Treasury bonds represented in the diagram had dropped from around 3½ per cent in 1933 to close to 2 per cent, and the adjusted price index had risen from around 95 to over 110.

Influence of the War

With the outbreak of war the attitude of investors has changed abruptly. Even before hostilities commenced, the growing apprehension had been reflected in pressure upon high grade bond prices. This rapidly increased after the fighting started. As indicated by the diagram, prices of government bonds experienced the sharpest decline since 1931, when the departure of Great Britain from the gold standard precipitated heavy foreign gold withdrawals from this country, with severe deflationary consequences to the credit structure. By the end of September, prices of long-term Treasury issues were down to about where they were after the setback in early 1937, and the average yield on the market values had risen over ½ of 1 per cent.

Naturally these developments have raised a question as to the future of interest rates. Investors are wondering whether we may not have passed the low point of the long downward cycle and are not now entering upon a new phase of advancing rates.

Bond Market Break Not Due to Fundamental Money Conditions

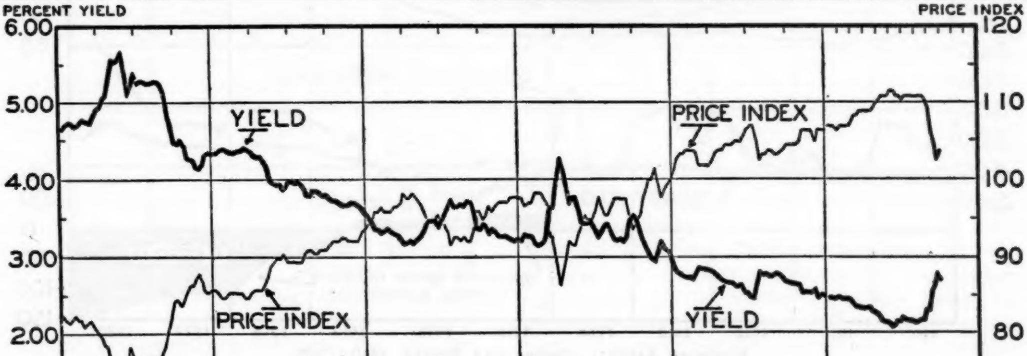
In considering the above question, it should be recognized at once that the decline that has taken place in bond prices, with accompanying rise in yields, is not the result of any change to date in basic money conditions. The huge surplus of money market funds, which has been the principal cause of low interest rates, has not diminished. On the contrary, it has risen higher than ever before. Thus at the end of September the excess reserves of member banks stood at an all-time peak of $5,330,000,000, an increase of over $500,000,000 for September alone and of $1,000,000,000 since last Summer when the bond market reached its top.

The causes of this great increase in available funds were mainly twofold: (1) the continuing inflow of gold, and (2) the action by the Reserve Banks in adding $380,000,000 net to their government security portfolio in September.

From the figures it seems clear that what has taken place in the bond market has been largely a change of psychology. Investors, in other words, are no longer acting upon the known conditions of the present, but rather upon their expectations of conditions in the future. It remains to be seen whether these expectations will prove correct.

Experience of the Last War

At this point a brief review of what happened to money rates during the last war should be of interest. Turning to the diagram on page 116, it will be seen that, after an initial period of stringency caused by recall of foreign balances, interest rates, both short and long, declined. In the case of short-term rates, represented by commercial paper, the decline continued throughout 1915, reaching the low



Average Yield on Long-term Treasury Bonds and Price Index on Basis of 3 per cent 15 Year Issue. Monthly averages for 1919-38; weekly figures for 1939.

point about the end of that year, approximately a year and a half after the outbreak of war. From there on the rate showed little change until the middle of 1916 when a rise began which did not, however, become pronounced until 1917, fully two and a half years after the war started.

In the case of long-term interest rates, as represented by the yield on high grade bonds, the period before any rise took place was even greater. Thus it was not until early in 1917 that bond yields reached their low, although after that the upturn was quite rapid, in conjunction with increasing short-term rates, as the United States entered the war. By 1918 commercial paper rates had risen from around 4 per cent at the outbreak of the war to 6 per cent, while bond yields had advanced from around 4 per cent to nearly 5. In 1920, approximately two years after the close of the war, both commercial paper rates and bond yields reached their peak.

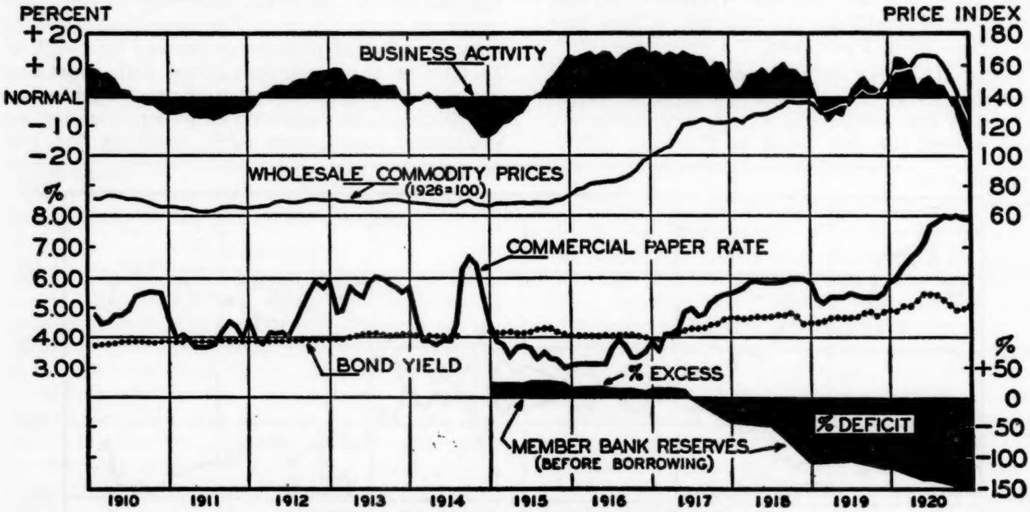
The explanation of the failure of interest rates to rise during the early years of the World War is pertinent to our problem today, and apparently lies partly in the trend of business activity and prices at the time, and partly in the condition of the money market.

As the diagram below shows, business was headed downward when the war broke out and continued to decline until the end of that year. While a turn occurred at that point, it was not until the latter half of 1915 that the general level of business reached the so-called normal, and commodity prices did not begin to rise until late in 1915. However, even when prices and business did rise very vigorously late in 1915 and in 1916, interest rates remained low, up until we entered the war in 1917. Thus a very substantial increase in the demand for money had little effect on rates.

The reason appears to be that the supply of money market funds was increasing faster than the demand as it was very largely augmented from two sources: first, from the reduction of bank reserve requirements which accompanied the inauguration of the Federal Reserve System and greatly increased the quantity of lendable funds, and, second, from gold imports which began as early as 1915 in payment for Allied purchases, and in that year and in 1916 amounted altogether to nearly $1,000,000,000 net, an extremely large sum for those times.

The result of this combination of circumstances was to create a condition of excess bank reserves, similar in character if not in degree, to that existing today. In 1915 the reserve excess of banks then members of the Reserve System ran as high as 27 per cent of reserve requirements, and substantial surplusages continued to be reported through 1916 and up to the middle of 1917 before they were eliminated by the rising tide of deposit expansion and increased currency demand created by war-time borrowing and price increases.

In the diagram, the lower shaded area shows the percentage of excess or deficit in reserves of member banks before rediscounting with the Federal Reserve Banks, for the period 1914 to 1920 inclusive.



Business Activity, Prices and Money, 1910 - 1920

Business Activity: Index of Cleveland Trust Co., percentage deviations from computed normal. Wholesale Commodity Prices: U. S. Bureau of Labor Statistics, base 1926 = 100. Interest Rates: Commercial paper rate and adjusted index of yields of high grade railroad bonds. Source: Bond yields, Interest Rates and Stock Prices, by Frederick R. Macauley. Member Bank Reserves, before borrowings from Federal Reserve Banks, are shown as percentages of required reserves.

1914 and 1939 Compared

To what extent the experience of the last war will prove a reliable guide to interest rates at present, is of course unknown. It may be well to bear in mind that in various ways the situation today is not comparable with that in 1914. Not only are interest rates much lower, but, as previous discussion has shown, the trend of business and prices both before and after the outbreak of war has been different. Moreover, the technique of monetary and non-monetary controls is more highly developed now than it was then.

From the standpoint of the available supply of funds, there can be no question but that the situation is vastly stronger today than in 1914. Comparative figures of gold and excess reserves have been recited so often they need not be repeated here. Nor is there any indication of a weakening of this position as far ahead as one may see with any reasonable assurance. The only question of doubt relates to the demand for funds, and this depends on the degree and character of the war requirements which are still uncertain.

Money and Banking in September

Changes last month in the domestic money and banking position reflected the impact of war upon conditions long abnormal. As noted above, the excess reserves of member banks rose over $500,000,000 to the unprecedented total of $5,330,000,000. Continued heavy imports of gold, principally from Great Britain and Canada, plus releases from earmark, carried the country's monetary gold stock to almost $17,000,000,000.

An increase of $205,000,000 in loans for commercial, industrial and agricultural purposes was made by the weekly reporting member banks during the first three weeks of September. Business loans in this classification, which includes "term loans," have now recovered to the highest point since April 1938. For the remainder of the year, the upward seasonal trend of such credit may be accentuated by the current expansion of industrial production, the rush of new orders placed and the higher level of raw material prices. Banks have experienced an increase of inquiries for prospective domestic loans, chiefly in the smaller category, and also for commercial credits in connection with foreign trade, including movement of goods between foreign countries formerly financed in London.

Loans against securities, on the other hand, decreased last month, despite the upward movement of security prices and the greatly increased volume of trading on the stock exchanges. That such loans should decrease under the circumstances, even establishing a new low record for many years back, is evidence of the preponderantly "cash" character of the present market and the indisposition of the public to borrow for the purpose of carrying stocks. The reduction by dealers of their portfolios of government securities, together with the absence of new corporate issues, was also a factor in the decline in reported "street" loans.

The Bond Market

Reference has been made earlier to the effect of the outbreak of war upon prices of high grade bonds. Selling affected all groups of prime obligations with almost equal severity, and the foreign list was particularly hard hit with some exceptions, notably certain of the Latin American issues. Contrasting with the trend of so-called "money" bonds, many of the lower-rated issues, especially among the rails, scored large advances upon the expectations of increased volume of business and better earnings.

Towards the close of the month the market for the better grade bonds gave indications of being oversold and prices rallied quite generally from the lows. The following table shows the extent of decline in various maturities of Treasury securities from the June high points to prices September 28, latest quotations being approximately 1¾ points on long bonds and ¾ of a point on long notes above the minimum levels.

Declines in Government Security Prices

U. S. Treasury Bonds	June High	Price Sept. 28	Points Decline	Yield Sept. 28
2's, 12/15/47	106- 1/32	100-16/32	—5-17/32	1.93%
2½s, 1952-50	107-22/32	100-28/32	—6-26/32	2.40%
2¾s, 1965-60	108-16/32	100-26/32	—7-22/32	2.71%
U. S. Treasury Notes				
1¾s, March 15, 1942	104-16/32	103- 4/32	—1-12/32	.44%
1⅛s, June 15, 1943	102-26/32	100-23/32	—2- 3/32	.94%
¾s, June 15, 1944	101- 6/32	99	—2- 6/32	.97%

In addition to heavy System purchases of government securities in the open market, a number of the regional Reserve banks took the step of reducing their discount rates on advances secured by government paper from 1½ to 1 per cent; also, the discount privilege was broadened generally to admit non-member bank government paper on the same basis as that of member banks. Inasmuch as under present conditions few banks are under the necessity of borrowing from the central bank, the action taken was apparently intended as a reassuring gesture to induce banks to hold "governments" rather than press them for sale.

Over the first three weeks of September, statements of the weekly reporting banks revealed a drop of $193,000,000 in their investments in government direct and guaranteed obligations, due mainly to reductions in bill and note holdings and in guaranteed bonds for which a substantial maturity was partly responsible. As indicated by the following summary, banks in New York and Chicago

increased their holdings of Treasury bonds during the period.

Changes in Government Security Holdings of Weekly Reporting Member Banks, August 30 — September 20, 1939
(In Millions of Dollars)

Issues	Total	New York	Chicago	Other
Bills	— 65	+67	—111	— 21
Notes	— 29	—36	+ 3	+ 4
Bonds	— 43	+31	+ 8	— 82
Guar. bonds	— 56	—40	+ 2	— 18
Total	—193	+22	— 98	—117

The Situation in Sterling Exchange

Following the outbreak of war the exchange markets opened with sterling quoted in London at official rates of $4.02 - $4.06, and outside markets slightly higher. Gradually the rate declined to $4.02 by September 13, and when the British control failed to support it at that level, as had been expected, opened on September 14 at $4.00 and quickly dropped to $3.75 on very little business. Later in the day word was received in New York to the effect that any American demand for dollar exchange would be satisfied in London at $4.02 if such demand was in connection with liquidation of American-owned pre-war sterling balances or with current trade transactions with the British Empire. This stopped the decline in the market, and for about a week, pending clarification of the situation, the rate fluctuated within narrow limits, subsequently recovering slowly to the $4.02 level. As we understand it now, the official $4.02 rate is for approved imports into England, and for such imports the British Government is undertaking to assure dollars to importers at that price. As far as we know, there is at present no public list of approved imports, but each item has to be submitted. However, up to the present writing there has been no difficulty in converting cotton bills.

Most currencies allied with sterling remained so related, except the Scandinavians. While the Japanese yen remained tied to the pound as far as $4.02, it did not go below.

The Canadian Government has issued exchange regulations covering imports and exports of merchandise and movement of capital, and has been fixing daily an official exchange rate which has ranged from 9 to 10 per cent discount.

Anglo-French Gold and Foreign Assets

The possible effects of the war upon our trade with belligerent countries, and the means by which they will make payment for purchases, are important questions to which only approximate or tentative answers can be given at present.

During the last war, a substantial share of our net exports was financed by European government loans sold to the American public and by credits extended by American banks. After our entry into the war in April 1917, the United States Government made large direct loans to the Allied Powers. At the present time, however, these sources of credit have been eliminated by the Johnson Act of 1934 and the Neutrality Act of 1937.

The table below, prepared by the Institute for International Finance of New York University, shows that during the period 1914-17 practically one-third of the sum due us from the Allies and neutrals in settlement of the export surplus in our merchandise trade with them was financed by loans contracted in this country. Approximately 40 per cent was paid for by the resale to us of American securities, about 15 per cent by net gold shipments and the remainder by various services.

Means of Payments by Europe to the United States, July 1914-July 1917
(In Millions of Dollars)

Net gold shipments to the United States	$1,210
Resale of American securities	3,160
Loans contracted in the United States	2,600
Income on investments in the United States	250
Immigrant remittances to Europe	300
Freight charges on United States shipments	700
	$8,220

Trade Balances Available for Payments

The problem of chief interest at present narrows down to how Great Britain and France will finance imports from this country, inasmuch as our trade with Germany has been practically shut off by the Allies' control of the sea.

In peace-time, both Great Britain and France paid for their excess of imports by tourist trade, shipping and other services. About one-half of our 1937 merchandise trade surplus with the United Kingdom totalling $300,000,000 was settled by invisible items, of which tourist expenditures and shipping commissions contributed about $70,000,000.

Inasmuch as the war will both handicap the rendering of various services by the British and restrict their merchandise exports, it seems likely that credits accruing to us in our balance of payments with the United Kingdom may be considerably greater than in peace-time. On the other hand, the imposition of import regulations, greater reliance upon Empire resources and rigid restrictions upon capital movements will tend to reduce the pressure upon the exchanges, and there is a possibility that the Crown Colonies and the Dominions may earn more dollars through increased sales of raw materials to us at higher prices.

Gold and Foreign Assets

Because of the uncertainty as to the extent to which Great Britain and France will be able to adjust their balance of payments through control of trade and capital movements, and greater reliance upon Empire resources, the question as to the size of their

holdings of gold and other assets readily convertible into foreign exchange becomes important.

Resources most readily available for use in this market are of four principal kinds: (1) gold, (2) bank balances and short-term investments in the United States, (3) negotiable dollar securities, and (4) direct investments (business participations) here, the liquidation of which, however, is often difficult.

The following table gives rough estimates of the gold and U. S. investments of Great Britain and France now and in 1914:

British and French Gold Holdings and Dollar Assets
(In Millions of Dollars)

	1914	1939
British Gold & Dollar Assets		
Gold at home and abroad	$795	$2,200
Bank balances in U. S.	270	580
American negotiable securities	3,650	1,090
Direct investments in U. S.	600	700
Total	$5,315	$4,570
French Gold & Dollar Assets		
Gold at home and abroad	$1,750	$3,025
Bank balances in U. S.	30	275
American negotiable securities	365	285
Direct investments in U. S.	45	25
Total	$2,190	$3,610
Combined Total	$7,505	$8,180

Before drawing any conclusions from the above table, certain qualifications are desirable. The pre-war gold stock of Great Britain consisted of $195,000,000 in the Bank of England and some $600,000,000 divided about evenly between private banks and circulation. The French stock included $783,000,000 in the Bank of France and nearly $1,000,000,000 in private banks and in the hands of the public. After the outbreak of war, both the British and French Governments endeavored to draw all the gold into their central banks, but the efforts in Great Britain were more successful in this respect than in France, where only about one-half was given up by the public.

At the outbreak of the present war, substantial amounts of gold were held privately in London, estimated at about $1,500,000,000 in September 1938, but believed to have been reduced by about four-fifths since then.

Estimates of the gold held at present by the Bank of England and the Equalization Fund are rough approximations at best. Latest official figures placed the gold in the Fund at $1,732,000,000 in March 1939. During the ensuing five months, the net exports of gold exceeded $900,000,000, but a portion of the exports was earmarked abroad for British account. Moreover, during that period the Fund acquired a considerable quantity of dehoarded gold. An average of private estimates places the gold holdings of the Fund at the outbreak of the war at somewhat above $1,000,000,000, when $1,162,000,000 was transferred to it from the Bank of England.

Greater Availability of Present Assets

It would appear, therefore, on the basis of the above estimates that the Anglo-French gold and dollar assets at the outbreak of the new European war were somewhat in excess of those in 1914. Moreover, they were in a form much more readily available. Their gold assets alone are twice as large as in 1914 and are now concentrated in central banks, whereas in 1914 over 60 per cent of their gold was in circulation. It should be borne in mind, of course, that the 1914 figures are in dollars of the former standard of value; however, in terms of purchasing power over goods there has been little change.

While the Anglo-French holdings of negotiable dollar securities are much less than at the outbreak of the last war, the technique for their mobilization for the financing of trade and the support of exchange is much better developed. Steps to marshal bank balances and negotiable dollar securities were taken several months ago. In the last war, such steps were not taken until 1915, when the British Government invited the sale to itself of American securities owned by British investors, and two years later made such sale compulsory.

In addition to the gold and dollar assets of Great Britain and France, consideration may well be given to their extensive investments in the Dominions and Colonies. These include numerous Canadian securities, Rhodesian copper shares, Rand mining shares and large British investments in neutral countries such as South America, many of which doubtless could be sold in the New York market for dollars. British investments in Canada have been estimated at about $2,500,000,000, in South Africa at $1,250,000,000 and in Argentina at $2,200,000,000. Just how large a portion of these securities the British Government would be willing to transfer to other countries is, of course, uncertain, and there is also the question as to how much the foreign security markets could readily absorb. In the case of gold, however, there would probably be a greater willingness by the British Government and public to part with the metal now than in 1914, when emphasis upon gold as a backing of currency was much stronger than it is today.

Finally, it should be pointed out that an important continuous source of dollar exchange available to the Allied powers lies in their new production of gold. Approximately $730,000,000, or nearly two-thirds of the world output of gold (outside of Russia), was produced within the British and French Empires in 1938, whereas in 1914 their annual production was but $260,000,000.